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No. 90-1918

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

KRAFT GENERAL FOODS, INC.,
(Formerly Kraft, Inc.),
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Petition For Writ Of Certiorari To The Supreme Court Of Iowa

PETITIONER'S REPLY TO BRIEF IN OPPOSITION

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PETITIONER'S REPLY TO BRIEF IN OPPOSITION

I. Respondent's Inability to Find a "Local Benefit" Does Not Negate Iowa's Impermissible Discrimination Against Foreign Commerce.

In undertaking to defend the Iowa Supreme Court's conclusion that a "local benefit" test is the correct test to be applied in determining impermissible discrimination against foreign commerce, respondent devotes almost all of its energies to establishing that there is no local benefit produced under the Iowa taxing scheme. As respondent puts it, "[t]he Iowa tax-

structure does not encourage, protect or otherwise advantage instate activities at the expense of out-of-state activities." (Resp. Br. Op. 7)

Significantly, however, the court below expressed genuine uncertainty as to whether it was applying the proper standard—". . . Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged. . . ." (Pet. App. 7a) It is no surprise, therefore, that respondent is unable to cite a single case in support of its assertion that a finding of purely local bias is necessary to establish impermissible discrimination under the Foreign Commerce Clause. The only cases respondent does cite (*Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), and *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318 (1977), at Resp. Br. Op. 6) involved discrimination against interstate commerce, not foreign commerce. Respondent's attempt to distinguish *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), completely ignores the fact that this Court did not require a finding of purely local bias before striking down the Pennsylvania tax on foreign goods sold at auction.

The one citation offered by respondent that might appear supportive of the test applied by the court below is a 1986 article appearing in the Vanderbilt Law Review. However, the passage quoted by respondent (Resp. Br. Op. 11), which was also quoted by the court below, actually addresses a tax that discriminates against interstate commerce *in favor of foreign commerce*.[1] The commentators express quite

[1] Such a tax was precisely the type of tax considered in *Zee Toys, Inc.* v. *County of Los Angeles* and *Star-Kist Foods, Inc.* v. *County of Los Angeles*, both cited in petitioner's Petition for Certiorari (Pet. 16). In those cases, the Supreme Court of California reached a conclusion contrary to that advocated by the commentators, holding that the statute in question was unconstitutional even though there was no showing of local benefit.

a different view of the situation presented by a case such as the instant case, *i.e.*, where the statute discriminates *against foreign commerce* in favor of interstate commerce.

> It is also unclear whether a state tax provision can favor interstate commerce over foreign commerce. The additional protection afforded foreign commerce renders it unlikely that such a provision would be held constitutional.

Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 n.298 (1986).

The flaw in the Iowa Supreme Court's reasoning is that it believed it was required to find an advantage peculiar to local business, when a benefit to domestic commerce over foreign commerce is all that should be required. Even respondent seems to recognize that insisting upon an exclusively local benefit to establish impermissible discrimination cannot be reconciled with this Court's decision in *Cook* v. *Pennsylvania*. As a result, respondent seems to be suggesting that an instate benefit need only be *among* the benefits identified, rather than the *exclusive* benefit enjoyed.

But if an instate benefit need only be among the benefits identified, respondent should agree with petitioner that the Iowa taxing scheme is unconstitutional on its face. It is undeniable that under Iowa law, domestic subsidiaries, whether doing business in

Iowa ("Iowa businesses") or elsewhere, enjoy an advantage over foreign subsidiaries doing business abroad because dividends paid by the former are excluded from their parents' Iowa tax base while dividends paid by the latter are included. As a result, to achieve the same net funding level for the parent, a domestic subsidiary can pay a lesser amount of dividends than a foreign subsidiary. That in turn leaves the domestic subsidiary with more funds available for its own operations. The fact that such an advantage is afforded to Iowa businesses (in addition to other domestic businesses) should be all the local benefit necessary to establish discrimination against foreign commerce under respondent's local benefit test. Even under respondent's reading, *Cook* v. *Pennsylvania* supports that conclusion.

Respondent seeks to avoid the trap it has thus set for itself by pointing to the fact that Iowa also taxes an appropriate portion of the earnings of all subsidiaries doing business in Iowa. Respondent claims that the Iowa tax on such earnings should be viewed as neutralizing any benefit that is derived from the exclusion allowed for dividends paid by such subsidiaries. (Respondent even goes so far as to note that the earnings of subsidiaries located in most (though not all) other states are also subject to separate corporate income tax.)

Whether a subsidiary's earnings are subject to state income tax should not be relevant to the discrimination issue here presented. A tax on subsidiary earnings is quite different from a tax on the parent's receipt of subsidiary dividends. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 191 n.30 (1983). Moreover, if a tax on subsidiary earnings is

relevant to the inquiry, it must be recognized that the earnings of foreign subsidiaries may be subject to tax at both federal and local levels in the countries in which they operate. In addition, foreign subsidiary dividends may also be subject to yet another tax—a withholding tax imposed by the country from which the dividends are remitted, as was in fact the case here. (Pet. App. 53a.) There is thus no merit in respondent's suggestion that because of a domestic subsidiary's own income tax exposure, domestic subsidiary dividends do not enjoy an advantage over foreign subsidiary dividends when remitted to corporations doing business in Iowa.

The need for guidance by this Court on the discrimination issue here presented has become even more acute in the short time since petitioner's Petition for Certiorari was filed. In *Dart Industries* v. *Clark*, A.A. No. 87-2 (R.I. Dist. Ct. Sixth Div., June 19, 1991), a state district court (Moore, J.) upheld the constitutionality of a Rhode Island taxing statute which, like the Iowa statute, includes foreign subsidiary dividends but excludes domestic subsidiary dividends in computing the corporate income tax base. The court concluded that the Rhode Island statute did not violate the discrimination prong of the *Complete Auto* test because "all domestic corporations with foreign subsidiaries are treated the same." Slip op. at 5. (Copies of the unpublished opinion of the Rhode Island District Court have been furnished to respondent and lodged with the Clerk of this Court.)

The opinion of the Rhode Island court reflects a total misunderstanding of the discrimination issue presented. The question is whether dividends paid by foreign subsidiaries bear an impermissible burden rel-

ative to dividends paid by domestic subsidiaries, thereby adversely impacting their respective parent companies that are competing in Iowa and inappropriately influencing how those companies may choose to structure their business operations.

The Rhode Island decision underscores the necessity for this Court to articulate the correct test to be applied in cases involving a claim of impermissible discrimination under the Foreign Commerce Clause. To allow the decision below to stand without further review will perpetuate the uncertainty that now exists with respect to this fundamental constitutional question.

II. Convenience Alone Does Not Justify Iowa's Classification of Dividend Income.

Respondent contends that "taxpayer and administrative convenience" is a legitimate purpose for Iowa's taxation of corporations receiving foreign subsidiary dividends on a more onerous basis than corporations receiving domestic subsidiary dividends. In support of its position, respondent cites two cases in which this Court accepted administrative convenience as an appropriate justification for a state's differentiation in the treatment of certain taxpayers. *Carmichael* v. *Southern Coal Co.*, 301 U.S. 495, 511 (1937) (administrative convenience and expense in the collection or measurement of tax may justify differentiation in the treatment of small taxpayers; expense and inconvenience of collecting tax may be disproportionate to revenue obtained); *Madden* v. *Kentucky*, 309 U.S. 83, 87-90 (1940) (higher ad valorem tax on bank deposits of residents placed outside the state than on bank deposits placed within the state held justifiable where "[t]he treatment accorded the two

kinds of deposits may have resulted from the differences in the difficulties and expenses of tax collection").

As is clear from the foregoing, the different groups of taxpayers involved in the cases cited by respondent were not "similarly situated." Differences in their circumstances (small incomes v. large incomes; out-of-state depositors v. in-state depositors) justified the differences in tax treatment afforded, even where those differences were motivated by considerations of convenience in tax administration. Respondent fails to cite any authority recognizing administrative convenience as a justification for discrimination with respect to taxpayers that *are* similarly situated, such as corporations doing business in Iowa that have no differences in their own circumstances but simply receive their dividends from different sources.

Moreover, respondent concedes that if, for purposes of convenience, Iowa were to subject an Illinois corporation doing business in Iowa to tax based on its net income as calculated for Illinois tax purposes, Iowa would be engaged in a "wholly arbitrary act" that violates the Equal Protection Clause. (Resp. Br. Op. 20 n.5) Thus, respondent asserts that the convenience of using numbers from another return *would not* be sufficient justification for taxing all the income of certain corporations (those from Illinois) differently than all the income of other corporations (those from elsewhere). Yet, respondent also asserts that such convenience *would* be sufficient justification for taxing the dividend income of certain corporations (those with domestic subsidiaries) differently than the dividend income of other corporations (those with foreign subsidiaries). To draw a distinction between domestic and

foreign dividend income merely because it is convenient to do so, and to tax one class but not the other, is to act in the "wholly arbitrary" manner that respondent concedes is unconstitutional.

The values implicated by the Equal Protection Clause would be totally undermined if the "taxpayer and administrative convenience" that may come from using federal numbers were allowed to justify excluding one category of dividend income while including the other when received by similarly situated taxpayers. To hold otherwise would completely eviscerate the meaning of "equal protection" in this context.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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